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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 1085

WATERMAN STEAMSHIP CORPORATION,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITIONER'S REPLY MEMORANDUM

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The Respondent argues on pages 8 and 9 of its brief that the sale by Petitioner of its subsidiaries' stock resulted in a profit of $2,799,820 to Petitioner's consolidated group, and that as this asserted profit resulted from a transaction with a person outside of the consolidated group it should be taxed. That argument, which was first raised in Respondent's brief, brings into focus the basic fallacy in the Respondent's position that the sale resulted in the realization of taxable income by Petitioner.

The Petitioner actually realized no profit from the sale. Respondent admits in footnote 3 on page 5 of its brief that Pan-Atlantic had accumulated "earnings

and profits of at least $2,799,820" at the time of the sale. Those profits were previously taxed profits of the consolidated group and since they had been realized prior to the sale the sole effect of the sale was to convert such existing profits into cash. The consolidated group must be considered as one, and Petitioner, therefore, derived no taxable income from the sale.

Analogizing the instant case to *Knetsch v. United States*, 364 U.S. 361, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960) and *Goldstein v. Commissioner*, 364 F.2d 734 (C.A. 2), *cert. denied*, 385 U.S. 1005, the Respondent argues that the declaration and the payment of the "dividend" in the instant case should be disregarded since it had no purpose, substance or utility apart from Petitioner's desire to secure a tax benefit. (Br. Op. 8.) Respondent's analogy is misplaced and its argument is without merit and demonstrates Respondent's failure to perceive the real substance and realities of the events here in question. In *Knetsch* the evidence clearly established that there was nothing of substance to be realized by the taxpayer from the annuity contract transaction beyond a tax deduction. In *Goldstein* the taxpayer engaged in "purposeless activity" (Borrowing at 4%, with the prepayment of interest, to purchase 1 1/2% Treasury obligations) "without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction" which the Court of Appeals concluded would frustrate the statutory purpose by encouraging "transactions that have no economic utility and that would not be engaged in but

for the system of taxes imposed by Congress". (364 F.2d at 743) In these cases the taxpayer entered into a transaction for the sole purpose of obtaining a tax deduction. Such is not the instant case. Here the "transaction" was entered into for the purpose of converting Waterman's stock interest in Pan-Atlantic into cash and not for the purpose of obtaining a tax benefit.

There was also substance to the transaction in that Securities was able to acquire Pan-Atlantic and Gulf Florida with a limited equity investment of $700,000 and the use of the "debt" of one of the acquired corporations thus making a "bootstrap" acquisition. However, such was not without adverse consequence as Securities' adjustgd cost basis in the stock of the subsidiaries was limited to $700,000.

Respondent emphasizes the short life of Pan-Atlantic's indebtedness to Waterman, but ignores the fact that Pan-Atlantic's notes aggregating $2,799,820 to Securities and McLean remained outstanding obligations of Pan-Atlantic for more than three years. The issuance of these promissory notes to Securities and McLean was as much as integral part of the transaction as was the payment of the "dividend note" given Waterman, as it was known that these funds would be "lent" to Pan-Atlantic and not contributed to its capital. Although Respondent would erroneously infer that Securities (whose stock was publicly held and publicly traded) was Mr. McLean's alter ego, there is substance in the fact that Mr. McLean, who owned only 64% of the stock of Securities at the time of the acquisition,

"lent" its subsidiary $2,500,000 rather than contributing such sum to the capital of Securities in exchange for stock of Securities or to the capital of Pan-Atlantic in exchange for stock of Pan-Atlantic.

The Respondent admits that the Courts of Appeals have not been uniform in their acceptance of the Fifth and Sixth Circuits' approach to the scope of review permitted an appellate court and that resolution of that issue by this Court may ultimately be necessary, but argues that the present case is not an appropriate vehicle for such review. The similarity of the circumstances and issues in the instant case and *Cumberland* makes it clear that there exists a direct conflict between the views of the Court of Appeals below and this Court regarding the proper functions of the trier of fact and the reviewing appellate court. Furthermore "the current, more realistic approach to appellate review," of the Fifth and Sixth Circuits, limiting the factual determinations of the trial court to "various objective indicia of a commercial transaction", is clearly inconsistent with the view of this Court that "The [clearly erroneous] rule itself applies also to factual inferences from undisputed basic facts." *United States v. United States Gypsum Co.*, 333 U.S. 364, 394, 68 S. Ct. 525, 92 L.Ed. 746 (1948); *Commissioner v. Duberstein*, 363 U.S. 278, 291, 80 S. Ct. 1190, 4 L.Ed. 2d 1218 (1960).

The Court of Appeals has erroneously determined an important question of Federal tax law going to the very nature of the Federal income taxation of corporations. The Congressional desire to avoid the multiple

taxation of corporate earnings as they pass from one corporation to another was first expressed in 1917 and was re-affirmed in 1964. (Pet. App. 12). In 1918 Congress adopted provisions providing for Consolidated returns "because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government." (Sen. Rep. No. 617, 65th Cong., 3d Sess., pp. 8, 9.) The strained construction placed on both the facts and applicable provisions in this case clearly frustrates and defeats these Congressional purposes.

With the regard to what constitutes a "distribution of earnings and profits", a "distribution of property" and a "dividend" — questions the resolution of which serve as the very basis for Federal income taxation of corporations and their shareholders — Petitioner has demonstrated that the decision of the Court of Appeals directly conflicts with decisions of this Court (and other courts) and clearly disregards applicable statutory provisions. (Pet. App. 14-16)

There was substance to the "dividend" here and therefore the effect of the Court of Appeals' decision is to overrule the principle that taxpayers have the right to arrange their business transactions so as to minimize the incidence of tax by whatever means the law permits. *United States v. Isham*, 84 U.S. 496, 21 L. Ed. 728 (1873), and *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451, 70 S. Ct. 280, 94 L. Ed. 251 (1951).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Wm. H. Armbrecht, counsel for Petitioners herein, hereby certify that on the day of February, 1971, I served four copies of the within Reply Memorandum on the Respondent herein, the United States of America, by mailing the same postage prepaid to The Solicitor General, Department of Justice, Washington, D.C. 20530.

Wm. H. Armbrecht